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Application of the Federal Rule of Bankruptcy Procedure Rule 2004 Balancing Test

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Introduction

Federal Rule of Bankruptcy Procedure 2004 ("Rule 2004") provides that "[o]n motion of *any* party in interest, the court may order the examination of *any* entity."[1] By its terms, the rule is broad. It is only marginally narrowed by Rule 2004(b) to require that examinations "relate only to the acts, conduct, or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate, or to the debtor's right to a discharge."[2] Given that Rule 2004 is broadly available in bankruptcy cases to "any party in interest" and that the target of the examination is unconstrained by any categorization, courts apply a balancing test to determine whether to grant a Rule 2004 motion. This memorandum explains that balancing test by examining the limitations imposed on an invocation of Rule 2004. Part I provides an overview of Rule 2004. Part II analyzes the elements of the balancing test and reviews how courts have applied the test to bankruptcy cases. Part III examines the "pending proceeding rule," which prohibits a party from circumventing the more stringent discovery rules under the Federal Rules of Civil Procedure in favor of the more liberal Rule 2004 when the parties are engaged in litigation.

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[1] *See* FED. R. BANKR. P. 2004(a) (emphasis added).
[2] *See* FED. R. BANKR. P. 2004(b).

Part I

Rule 2004 is intended to permit a party in interest to determine the extent of the estate's assets and recover those assets for the benefit of creditors.[3] Parties in interest generally include the trustee, creditors, the debtor and entities related to the debtor, and persons obligated to the debtor.[4] Section 1109(b) of title 11 of the United States Code (the “Bankruptcy Code”) provides that "[a] party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter."[5] Although the Bankruptcy Code does not include a definition of “party in interest,” it is clear that the term is not limited to the examples listed in Section 1109(b) because the rules of construction of the Bankruptcy Code state that "including" is not a limiting term.[6] Consequently, “courts must determine on a case by case basis whether the prospective party in interest has a sufficient stake in the proceeding so as to require representation.”[7]

Rule 2004 has fewer procedural safeguards than discovery under the Federal Rules of Civil Procedure and, as one court famously put it, discovery under Rule 2004 may “legitimately compared to a fishing expedition.”[8] However, Rule 2004 does not permit unfettered examination of an entity. “It may not be used for ‘purposes of abuse or harassment’ and it ‘cannot stray into matters which are not relevant to the basic inquiry.’”[9] Furthermore, a Rule 2004 discovery

[3] *See In re* Drexel Burnham Lambert Group Inc., 123 B.R. 702, 708 (Bankr. S.D.N.Y. 1991).
[4] *See* 9 COLLIER ON BANKRUPTCY ¶ 2004.02[6] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2018).
[5] *See* 11. U.S.C. § 1109(b).
[6] *See* 11 U.S.C. § 103(3).
[7] *See In re* Amatex Corp., 755 F.2d 1034, 1042 (3rd Cir. 1985).
[8] *See In re* Drexel Burnham Lambert Group, 123 B.R. at 711.
[9] *See In re* Table Talk Inc., 51 B.R. 143, 145 (Bankr. D. Mass. 1985) (quoting *In re* Mittco Inc., 44 B.R. 35, 36 (Bankr. E.D. Wis. 1984)).

motion will not be granted if the purpose of its invocation is to avoid the Federal Rules of Civil Procedure limits on discovery pertaining to pending litigation.[10]

Part II

"Bankruptcy courts have held that these motions are to be decided by balancing the competing interests of the parties, weighing the relevance of and necessity for the information sought by the examiner against the extent of inconvenience and intrusion to the witness."[11] That documents meet the requirement of relevance does not alone demonstrate that there is good cause for requiring their production.[12]

In re Mittco Inc., 44 B.R. 35 (Bankr. E.D. Wis. 1984), illustrates how the application of the balancing test results in the court granting the Rule 2004 motion. In that case, a creditor sought to examine a debtor's accountant by invoking Rule 2004. The accountant objected, fearing that the examination might expose information that could be used by third parties in separate, non-bankruptcy litigation. The court found that the aim of the examination was for the benefit of the bankruptcy estate and that the accountant was within the scope of Rule 2004's broad power to examine "any entity." These interests were balanced against the argument that the accountant's documents were protected by an "accountant-client privilege." The court quickly dispensed with this argument because such a privilege does not exist, and balanced the accountant's fear of resulting litigation against the "solid presumption" that the public's access to the discovery process should not be restricted.[13]

In contrast, the court in *In re Coffee Cupboard, Inc.,* 128 B.R. 509 (Bankr. E.D.N.Y. 1991), found that the Rule 2004 motion should be restricted after applying the balancing test to

[10] *See In re* Silverman, 36 B.R. 254 (Bankr.S.D.N.Y.1984).
[11] *See In re* Kreiss, 46 B.R. 164, 165 (Bankr. E.D.N.Y. 1985).
[12] *See In re* Public Service Co. of N.H., 91 B.R. 198 (Bankr. D. N.H. 1988).
[13] *See id.* at 37.

the history of that case. In that case, the movants had over two years "to take in depth discovery and obtain information relating to the Debtor's acts, conduct and property" before a plan of reorganization was confirmed.[14] The movants had previously conducted Rule 2004 discovery on the debtor during that two year period. Moreover, the movants were familiar with the operations of the debtor before it filed for bankruptcy because the movants represented the debtor as its attorneys, and the two parties had a history of antagonistic behavior. In light of these circumstances, the court limited further Rule 2004 examination to investigate an alleged stock transfer that was not included in the list of assets that accompanied the confirmed plan.[15]

Part III

Some courts have expressed concern that Rule 2004 examinations might be used to circumvent the safeguards of the Federal Rules of Civil Procedure, especially where an adversary proceeding is pending between the parties.[16] In this regard, courts have defined the limit of the seemingly boundless "fishing expedition." Rule 2004(a) is "properly used as a pre-litigation device to determine whether there are grounds to bring an action to determine a debtor's right to discharge or the dischargeability of a particular debt."[17] Rule 2004(a) is considerably more liberal than the discovery rules under the Federal Rules of Civil Procedure. For example, under a Rule 2004 examination, a witness has no general right to representation by counsel, and the right to object to immaterial or improper questions is limited.[18] As such, the general rule is that discovery under Rule 2004(a) is not permitted after an adversary proceeding has commenced. Where the parties are not involved in adversary proceedings outside of the Rule 2004(a) motion,

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[14] *See id.* at 514.
[15] *See id.* at 516–17.
[16] *See In re* Enron Corp., 281 B.R. 836, 841 (Bankr. S.D.N.Y. 2002).
[17] *See In re* The Bennett Funding Group, Inc., 203 B.R. 24, 28 (Bankr. N.D.N.Y. 1996) (citing Sweetland v. Szadkowski (*In re* Szadkowski), 198 B.R. 140, 141 (Bankr. D.Md.1996)).
[18] *See In re* The Bennett Funding Group, 203 B.R. at 28.

courts are considerably more lenient in applying the broad language to the facts and allowing discovery. After the commencement of an adversary proceeding, the trustee may conduct Rule 2004 examinations of entities which are not parties to or are not affected by the pending adversary proceeding because entities not affected by the pending adversary proceeding do not need the additional protection afforded by the Fed.R.Bankr.P. 7026.[19]

In *The Bennett Funding Group,* the court refused to grant the trustee's motion for Rule 2004 discovery because the examination would inevitably venture into areas pertaining to an adversary proceeding between the parties. The defendant and her family owned many bankrupt businesses and was accused of diverting funds from one of those businesses to another family owned entity for her benefit. The court acknowledged that the "financial superweb" created by the defendants made it impossible for even a well crafted Rule 2004 discovery proceeding to not venture into issues under the adversary proceeding. If the court permitted Rule 2004 discovery, it would in effect consent to the creation of a back door through which the trustee would circumvent the limitations of the Federal Rules of Civil Procedure. *The Bennett Funding Group,* 203 B.R. at 30.

Conclusion

The balancing test is widely used by bankruptcy courts when considering Rule 2004 motions. Courts adhere to the broad application of the statute by liberally granting motions for discovery under the rule. However, courts demand that movants cross a low threshold by proving that their inquiry is relevant to the bankruptcy proceeding, that the purpose of the examination is legitimate and not designed to harass the target entity, and that the invocation of the rule is not a disguised attempt to evade the considerably more narrow Federal Rules of Civil Procedure when the parties are engaged in pending litigation. Even with these limitations, Rule

[19] *See In re* Buick, 174 B.R. 299, 305 (Bankr. D. Colo.1994).

2004 retains its famous characterization as a “fishing expedition.” Courts merely require that the movants genuinely be interested in a catch.